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**From:**

**Sent:** Tuesday 03/03/2009 2:44 PM

**To:**

**Cc:**

**Subject:** Counsel Power Point Presentation Appraiser Penalties

This power point was prepared for Appeals and has been sent there already, marked as CCA. As you will see, it was prepared specifically for donations of facade easements. I think in the penalties section (beginning with slide 50) at least one of the effective dates is specific to facade easements so you will need to revise that for your purposes. There is only one slide on section 6695A so I don't know how useful this presentation will be for you -- you may need to elaborate more. But you may want to look at the slides on section 6694 because that section can also apply to appraisers.

Also, since you work in the area of estate and gift tax, you may encounter issues regarding facade easements and may find the entire presentation useful.

Best,

# Charitable Contributions of Façade Easements

## § 170

# Topics

- Charitable Contributions in General
- Charitable Contribution of a Façade Easement
- Substantiation
- Valuation
- Penalties
- Typical issues

**Note:** All references to code sections are to the Internal Revenue Code and all references to regulations are to the Income Tax Regulations.

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## Charitable Contributions in General Overarching § 170 requirements

**To be deductible under § 170, there must be:**

- A transfer
- Of property or money
- To a qualified donee
- With charitable intent and without receipt of economic benefit
- Of the donor's entire interest in property (there are exceptions to this rule)
- Proper substantiation

**See Pub. 526 "Charitable Contributions"**

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## Charitable Contribution of a Façade Easement

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### What is a façade easement?

- A type of conservation easement which may qualify as a charitable contribution under § 170.
- A restriction on making changes to the exterior of a historical structure.
- A partial interest in property (an exception to the § 170 “entire interest” rule (§ 170 (f)(3)(B)(iii)).

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## When is a façade easement deductible?

To be deductible, a façade easement must be a “qualified conservation contribution”

§ 170(h)

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## Qualified Conservation Contribution

A contribution –

- Of a qualified real property interest
- To a qualified organization
- Exclusively for conservation purposes

See § 170(h); § 1.170A-14

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## Qualified Real Property Interest

A façade easement is a “qualified real property interest” if it meets the conservation purpose of –

“the preservation of a certified historic structure”

See § 170(h)(4)(A)(iv)

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## Qualified Real Property Interest (cont'd) Certified Historic Structure

A “certified historic structure” means –

- Any building, structure, or land area which is listed in the National Register, or
- Any building which is located in a registered historic district (as defined in § 47(c)(3)(B)) and is certified by the Secretary of the Interior to the Secretary as being of historic significance to the district.

Must be so designated at time of transfer or on due date (including extensions) of return for taxable year transfer is made.

See § 170(h)(4)(C) (2006)

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## Qualified Organization

- A “qualified organization” or “eligible donee” must be —
  - Governmental unit;
  - Publicly-supported charity; or
  - Support organization described in § 509(a)(3) that is controlled by a governmental unit or a publicly supported charitable organization.
- Eligible donee must have the commitment to protect the conservation purposes and the resources to enforce the restrictions.

See § 170(h)(3); § 1.170A-14(c)(1)

While Pub. 78 provides list of exempt organizations, inclusion in this list does not make an organization an “eligible donee”; the commitment and resources test, described above, must be met.

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## Conservation Purposes

- Visual Access by Public to Historical Structure
  - Some visual access is required.
  - If not visible from public way, terms of easement must give public regular opportunities to view property.
  - See § 1.170A-14(d)(5)(iv) & (v) for factors and examples.

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## Exclusively for Conservation Purposes

No inconsistent use —

- No deduction if contribution would accomplish one conservation purpose while permitting destruction of another significant conservation interest.
- However, an inconsistent use **is** allowed **if** the use is necessary for the protection of the conservation purpose of the easement.

See § 1.170A-14(e)(2) & (3)

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## Exclusively for Conservation Purposes (cont'd) In Perpetuity

- Conservation purpose must be protected in perpetuity. § 170(h)(2)(C) & (h)(5)
- Any retained interest in property by donor and/or donor's successor in interest must be subject to legally enforceable restrictions.
  - The Deed of Easement should be recorded in state land records; the transfer must be complete under state law.
  - Language of deed must adequately protect the conservation purpose and its exclusivity.
  - Remote future event does not defeat perpetuity requirement. (§ 1.170A-14(g)).
  - Deed must restrict donee transfers (§ 1.170A-14(c)(2)).

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## Exclusively for Conservation Purposes (cont'd) In Perpetuity

- The “in perpetuity” requirement is in addition to the “exclusively for conservation purpose” requirement. (§170(h)(2)(C) & § 1.170A-14(e) & (g)).
- Extinguishment of easement: Conservation purpose can still be protected in perpetuity if –
  - Extinguished by judicial proceeding, and
  - Sale proceeds used by donee org consistent with conservation purpose
  - §1.170A-14(g)(6)

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## Exclusively for Conservation Purposes (cont'd) In Perpetuity

- A mortgagee must subordinate its rights in the property to the right of the donee organization to enforce the conservation purposes in perpetuity. (§ 1.170A-14(g)(2)).
- In most states, the subordination agreement must be recorded in public records.
- Must be a true “subordination”; a mere “acknowledgement” is not sufficient.

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## Example of Subordination Agreement

**ABC Mortgage Group** hereby acknowledges and agrees that it is the Mortgagee (Lender) under the Mortgage dated January 15, 2001, and recorded on February 1, 2001, Document # 10101010 in James County, California, and the holder of the Note secured thereby, and that **it hereby subordinates its rights** in the mortgaged property to the rights of the **DEF Land Trust** (Grantee) as set forth in the Deed of Conservation Easement, dated March 15, 2009, to enforce the conservation purposes in perpetuity.

- Name:           /s/
  - Title: Joan Smith, President
- Institution: ABC Mortgage Group

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## Special Rule for Façade Easements added by Pension Protection Act (PPA), effective for contributions after 7/25/06

Façade easement not considered exclusively  
for conservation purposes unless it –

- Includes a restriction that preserves the **entire** exterior of the building (including the front, sides, rear and height of the building), and
- Prohibits any change inconsistent with historical character.

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## Special Rule for Façade Easements (cont'd)

- Donor and donee must enter written agreement certifying (under penalty of perjury) that donee –
  - Is qualified donee with a purpose of historic preservation, and
  - Has the resources to manage and enforce restriction and commitment to do so.

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## Special Rule for Façade Easements (cont'd)

For contributions made in a tax year beginning after 8/17/06, must include with tax return –

- Qualified appraisal (within meaning of § 170(f)(11)(E))
- Photos of entire exterior of building
- Description of all restrictions on development of building

See § 170(h)(4)(B)(iii)

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## Special Rule for Façade Easements (cont'd)

### **\$500 Filing Fee**

- No deduction allowed for charitable contribution of façade easement if claimed deduction is more than \$10,000 unless \$500 filing fee is paid with the return.
- Effective for contributions made on or after Feb. 13, 2007 (180 days after 8/17/06).

See § 170(f)(13)

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## Additional PPA changes Affecting Façade Easements

- Deduction up to 50% of contribution base
- Carryover of deduction for up to 15 years
- Effective for contributions made after December 31, 2005, through December 31, 2009

See § 170(b)(1)(E); Notice 2007-50; (termination date extended to 12/31/09 by Food, Conservation and Energy Act of 2008)

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## Substantiation

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## Substantiation

- Deduction only if “verified” under regulations § 170(a).
- Specific requirements are set forth in §§ 170(f)(8) & (11) and § 1.170A-13. Deduction should be disallowed if not met.
- Proposed regulations, issued August 2008, incorporate recent legislative changes. See REG-140029-07, 2008-40 I.R.B. 828.
- See also Pub. 1771 “Charitable Contributions – Substantiation and Disclosure Requirements”.

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## Mandatory Substantiation Requirements

- Contemporaneous written acknowledgment (CWA)
- Form 8283
- Qualified Appraisal
- Qualified Appraiser

Deduction must be disallowed if these requirements are not met!

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## Content of CWA IRC § 170(f)(8)

- Description (but not value) of donated property (the façade easement),
- Whether the donee provided any goods or services in exchange for the donation, and, if so
- A description and good faith estimate of the value of goods or services provided by the donee.

Deduction must be disallowed if these requirements are not met!

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## CWA (cont'd)

CWA is contemporaneous if obtained by on or before the date the a return is filed for the year in which the contribution is made, or the due date, including extensions, of such return.

See § 170(f)(8); § 1.170A-13(f)(3)

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## Form 8283/Appraisal Summary

If deduction is more than \$500 but not more than \$5,000:

- Form 8283 (Section A)

If deduction is more than \$5,000:

- Form 8283 (Section B/Appraisal Summary), and
- Qualified appraisal required

If deduction is more than \$500,000:

- Form 8283 (Section B/Appraisal Summary)
- **Must also attach qualified appraisal to return** (for contributions made after 6/3/04)

See § 170(f)(11)(B), (C) and (D)

### Note:

"Special Rule for façade easements", for façade easement contributions made in a taxable year beginning after 8/17/06, a qualified appraisal must be attached to tax return for **any** amount of deduction. 170(h)(4)(B)(iii)(I) . See slide 19.

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## Form 8283 (cont'd) Appraisal Summary (Section B)

- Date of the contribution
- Fair market value
- Detailed description of property
- How and when obtained
- Cost or other basis
- Name, address, TIN of appraiser, donor, donee
- Declaration of appraiser
- Signed and dated by donee and appraiser
- Donee signature acknowledges
  - Qualified organization
  - Receipt of property and date
  - Form 8282 if disposition within 3 years
  - Unrelated use question

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## Qualified Appraisal (Timing)

Appraisal must be made --

- No earlier than 60 days before contribution, and
- No later than due date (including extensions) of return

See § 1.170A-13(c)(3)(i)(A)

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## Qualified Appraisal (Content)

- Detailed description and physical condition of property
- Date of contribution
- Terms of any agreement or understanding related to use or disposition of property
- Name and qualifications of appraiser
- Prepared for income tax purposes
- Date property appraised
- Appraised fair market value
- Method of valuation
- Specific basis for valuation

See § 1.170A-13(c)(3)(ii)

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## Qualified Appraiser

Appraiser must declare on appraisal summary that he or she –

- Holds self out as appraiser or regularly performs appraisals
- Is qualified by experience, education, etc., to value type of property being valued
- Understands § 6701 civil penalty for aiding understatement of tax

See § 1.170A-13(c)(5)(i)(D)

**Note:** For returns filed after February 16, 2007, the declaration required under § 1.170A-13(c)(5)(i) must include an additional statement that the appraiser understands that a substantial or gross valuation misstatement resulting from an appraisal of the value of property that the appraiser knows, or reasonably should have known, would be used in connection with a return or claim for refund, may subject the appraiser to a civil penalty under § 6695A. See Notice 2006-96.

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## Qualified Appraiser (cont'd)

- Donor's knowledge that appraisal exceeds FMV can disqualify appraiser for that donation.  
§ 1.170A-13(c)(5)(ii)
- Appraiser cannot be donor, donee, person who sold or gave property to donor
  - Cannot be agent, related person, or employee
  - Cannot be regularly used by donor; must perform majority of appraisals for others
- Fee cannot be based on percentage of appraised value

See § 1.170A-13(c)(5) & (6)

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## Pension Protection Act of 2006

Applies to returns filed after 8/17/06

### **New requirements for Qualified Appraisal and Qualified Appraiser**

Appraisal must be conducted by qualified appraiser in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed by the Secretary.

See § 170(f)(11)(E)(i)(II)

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## PPA New Requirements (cont'd)

- Qualified Appraiser:
  - Has earned appraisal designation from recognized professional appraiser organization or has met requirements in regulations;
  - Regularly performs appraisals for compensation;
  - Must demonstrate verifiable education and experience in valuing the type of property subject to the appraisal, and
  - Has not been prohibited from practicing before the IRS any time in prior 3 years.

See § 170(f)(11)(E)(ii)

**Note:** Effective for returns or submissions filed after 8/17/2006

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## Notice 2006-96

### Section 3.02

- Provides transitional guidance after PPA and before regulations issued
- Appraisal treated as qualified if it complies with existing regulations (if consistent with PPA), and
- Is conducted by qualified appraiser in accordance with generally accepted appraisal standards.
- Appraisal will be treated as satisfying generally accepted appraisal standards if, for example, appraisal is consistent with substance and principles of USPAP.

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## Notice 2006-96 (cont'd)

### Sections 3.03 & 3.04

Qualified Appraiser treated as meeting new requirements of § 170(f)(11)(E) if –

- Appraisal designation awarded on basis of demonstrated competency in valuing type of property for which appraisal performed.
- Appraiser makes written declaration that background, experience, education and membership in professional associations qualifies him or her to appraise this type of property.
- Appraiser has minimum experience for appraisals of real property if --
  - For returns filed on or before 10/19/06, meets requirements of existing regulations.
  - For returns filed after 10/19/06, is licensed or certified for type of property being appraised in state of property location.

Penalty declaration: For returns filed after 2/16/07, appraiser must make written declaration of knowledge of new §6695A civil penalty.

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## Substantial Compliance Never Applies to § 170(f)(8)

- No court has applied substantial compliance to § 170(f)(8) – the CWA requirement.
- Tax Court position is that to allow a deduction when no CWA would “contravene the statutory text and the purpose of recordkeeping for contributions in excess of \$250.” See, e.g., *Stussy v. Commissioner*, 2003-232; *Weyts v. Commissioner*, 2003-68; *Kendrix v. Commissioner*, 2006-9.

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## Substantial Compliance has rarely been applied to 170(f)(11)

- For § 170(f)(11), courts generally require strict compliance with precise terms of statute and regulations.
- In *Hewitt v. Commissioner*, 109 TC 258 (1997), *affd.* in unpub. opin., 166 F3d 332 (4<sup>th</sup> Cir. 1998), a deduction was disallowed for failure to meet the requirements of § 1.170A-13(c) (no qualified appraisal). See also *D'Arcangelo v. Commissioner*, TCM 1994-572 (failed to obtain qualified appraisal by qualified appraiser); *Jorgenson v. Commissioner*, TCM 2000-38 (failed to timely obtain qualified appraisals and failed to attach completed Form 8283).
- However, in *Bond v. Commissioner*, 100 TC 32 (1993), the court allowed a deduction where T's qualified appraiser had performed an appraisal and T attached Form 8283 to the return, containing all necessary information except the appraiser's qualifications. The Service has not acquiesced in the *Bond* decision.

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## Valuation

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## Fair market value General Rule

- FMV is “the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.” § 1.170A-1(c)(2)
- If property is LTCG, deduction is generally (but not always) FMV; otherwise, reduce by appreciation. § 170(e).

See Pub. 561 “Determining the Value of Donated Property”

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## Comparable Façade Easement Sales

If substantial record of sales of façade easements comparable to donated easement exists, then FMV should be based on the sales prices of those easements.

See § 1.170A-14(h)(3)(i)

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## "Before and After" Valuation Method

- If no record of façade easement sales, use "before and after" method. §1.170A-14(h)(3)(i). Method not applied mechanically (S. Rept. No. 96-1007, 1980-2 C.B. 599, 606).
- FMV of easement is difference between FMV of property before granting of restriction and FMV of property after granting of restriction; two appraisals are required.
- If donor receives a benefit from the transfer
  - May be no deduction
  - Deduction only for excess
- If granting of restriction increases value of any other property owned by donor or related party (as defined in section 267(c)(4)), amount of deduction is reduced by that amount

See § 1.170A-14(h)(3)(i) & (ii); § 1.170A-14(h)(4), Examples 7 & 12

See *Whitehouse v. Commissioner*, 131 T.C. No. 10 (Oct. 30, 2008)  
(use of before and after method)

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## Highest and Best Use (HABU)

Value of property is based on the highest and best use of the property on the relevant valuation date.

To constitute the "highest and best use" of property, a use must be:

- (1) legally permissible
- (2) physically possible
- (3) financially feasible, and
- (4) maximally productive.

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## Highest and Best Use (HABU) (cont'd)

- HABU must take into account such factors as --
  - Current use of the property
  - Objective assessment of how immediate or remote the likelihood is that the property, absent the restriction, would be developed
  - Any effect from zoning, conservation, or historic preservation laws that already restrict the property's highest and best use

See § 1.170A-14(h)(3)(ii)

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## Highest and Best Use (HABU) (cont'd)

- Intent of the particular donor not at issue.
- Realistic assessment of what a reasonable owner would do with the property to put it to its best use.

See: Schwab v. Commissioner, T.C. Memo. 1994-232  
 Stanley Works & Subsidiaries v. Commissioner,  
 87 T.C. 389, 412 (1986)

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## "After" Value

- The conservation easement may have no material effect on value, or may enhance rather than reduce value. **No deduction is allowable for an easement that has no value.**

See § 1.170A-14(h)(3)(ii)

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## "After Value" (cont'd) Local Ordinances

- Often there are local ordinances restricting use and changes to façade.
- Compare easement to any existing restrictions on property (read deed of easement carefully)
- Easement should be valued only to extent easement restriction is more stringent than other restrictions already on property.

See §1.170A-14(h)(3) (ii)

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## No Safe Harbor/ No Percentage Reduction

FMV is based on facts and circumstances. Use of a percentage applied to the before value to determine the after value is not a methodology accepted by the IRS.

### **THERE IS NO SAFE HARBOR!**

- Some literature erroneously states that IRS will accept 10-15% reduction in value of property as facade easement valuation.
- Tax Court facade easement valuation cases during 1980's often were in that range, but these cases are not precedent for applying a percentage. Full appraisals are necessary.
- CCA 200738013 issued August 9, 2007: IRS will not accept appraisal to substantiate FMV of facade easement if the appraisal merely values entire fee before contribution and applies percentage reduction.
- Appraisal must do full valuation both before and after contribution.

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## Reduction in Contribution Amount for Rehabilitation Credit

If, during 5 preceding years, a rehabilitation credit under § 47 was claimed for the building, amount of deduction must be reduced by the following ratio –

Sum of credits/FMV of building on date of contribution

Added by PPA, effective for contributions after 8/17/08.

See § 170(f)(14)

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# Penalties

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## Potential Civil Penalties

- Accuracy Related Penalties under § 6662
- Tax Return Preparer Penalties under § 6694
- Appraiser Penalties under § 6695A
- Promoting abusive tax shelters, etc. under § 6700
- Aiding and Abetting Understatement of Tax liability under § 6701

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## Accuracy Related Penalty § 6662

Taxpayers may be subject to an accuracy-related penalty if they have an underpayment of tax required to be shown on a return. This penalty applies (in relevant part) to any portion of an underpayment that is attributable to:

- Negligence or disregard of rules or regulations.
- Any substantial understatement of income tax
- Any substantial valuation misstatement under chapter 1
- Any substantial estate or gift tax valuation misstatement

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### Reasonable Cause Exception: § 6664(c) Special Rule for Certain Valuation Overstatements

With respect to “charitable deduction property,” the reasonable cause and good faith exception to the § 6662 accuracy-related penalty does not apply to any underpayment attributable to a substantial or gross valuation overstatement unless –

- The taxpayer shows that the claimed value of the property was based on a qualified appraisal made by a qualified appraiser, **and**
- In addition to getting the appraisal, the taxpayer made a good faith investigation of the value of the contributed property.

See § 6664(c)(2); § 1.6664-4(h)(1)

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## Whitehouse Hotel Ltd. Partnership v. Commissioner, 131 T.C. No. 10 (Oct. 30, 2008)

### § 6662 Accuracy-related penalty applied.

- Taxpayer-partnership's valuation of façade easement was gross valuation misstatement.

### § 6664 Reasonable cause exception did not apply.

- Taxpayer had obtained qualified appraisal by qualified appraiser, but Taxpayer-partnership did not make good faith investigation of value as required by 6664(c)(2). (No Taxpayer-partner with personal knowledge made any showing of investigation.)

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## Tax Return Preparer Penalties: § 6694

A tax return preparer may be subject to a penalty for understatement of taxpayer's liability on a return or claim for refund due to (1) an unreasonable position, or (2) willful or reckless conduct.

### Unreasonable Position:

- § 6694(a) imposes a penalty on a tax return preparer who prepares a return or claim for refund reflecting an understatement of liability due to an "unreasonable position" if the tax return preparer knew (or reasonably should have known) of the position.
- A position is unreasonable unless (i) there is or was substantial authority for the position, or (ii) the position was properly disclosed and had a reasonable basis.
- No penalty is imposed, however, if it is shown that there is reasonable cause for the understatement and the tax return preparer acted in good faith.

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## Tax Return Preparer Penalties § 6694 (cont'd)

### Willful or Reckless Conduct –

- § 6694(b) imposes a penalty on a tax return preparer who prepares a return or claim for refund if any part of an understatement of liability was due to:
  - a willful attempt in any manner by an income tax return preparer to understate the liability for tax on the return or claim; or
  - any reckless or intentional disregard of rules or regulations by a tax return preparer.

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## Appraisers and § 6694

- An appraiser may be subject to penalties under § 6694 as a non-signing tax return preparer if the appraisal is a substantial portion of the return or claim for refund and the applicable standards of care under § 6694 are not met.
- The IRS has discretion to impose the §§ 6694 and 6695A penalties in the alternative against an appraiser depending on the facts and circumstances of the appraiser's conduct. The IRS, however, will not stack the penalties under §§ 6694 and 6695A with respect to the same conduct. A separate regulation will provide guidance under § 6695A.

See Preamble to Tax Return Preparer Penalty Final Regulations, I.R.B. 2009-3 268, 275.

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## Appraiser Penalties § 6695A

A penalty may be imposed under I.R.C. § 6695A if –

- A person prepares an appraisal of the value of property and such person knows or reasonably should have known that the appraisal would be used in connection with a return or a claim for refund, and
- The claimed value of the property on a return or claim for refund which is based on such appraisal results in a substantial valuation misstatement, a substantial estate or gift tax valuation understatement or a gross valuation misstatement.

Effective 7/25/06 for returns involving an appraisal of a façade easement (PPA § 1219(e)(3)).

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## Aiding and Abetting Understatement of Tax Liability: § 6701

A penalty may be imposed under § 6701 on any person --

- Who aids or assists in, procures, or advises with respect to, the preparation or presentation of any portion of a return, affidavit, claim or other document;
- Who knows or has reason to believe that such portion will be used in connection with any material matter arising under the internal revenue laws; and
- Who knows that such portion, if so used, would result in an understatement of the liability for tax of another person.

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## Notice 2004-41

In certain transactions involving conservation easements where taxpayers are improperly claiming charitable contributions under § 170, the Service may –

- Disallow all or part of any improper deductions
- Impose penalties under § 6662
- Assess excise taxes under § 4958 against any disqualified person who receives an excess benefit from a conservation easement transaction, and against any organization manager who knowingly participates in the transaction
- Challenge the tax-exempt status of the organization
- Review promoters of conservation easement transactions; promoters, appraisers and other persons may be subject to penalties under §§ 6700, 6701 & 6694

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## Practical Tips

Look for the following—

- Legally-required substantiation; should disallow entire deduction if not properly substantiated.
- § 170(f)(8) statement (CWA)
- Properly completed Form 8283
- Is donee qualified? Commitment & resources
- Qualified appraisal? Qualified appraiser?
- Valued using before and after test?
- Was the taxpayer's use of the property already restricted by local ordinances? What has changed?
- Easement language: in perpetuity; inconsistent uses
- Is easement recorded?
- Subordination by mortgagee?
- Any quid pro quo received by donor?

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